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THE JAPANESE ECONOMY

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BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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Tuesday, July 26, 1994

SUBMISSIONS FOR THE RECORD

THE JAPANESE ECONOMY

TUESDAY, JULY 26, 1994

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:55 a.m., in room 2359, Rayburn House Office Building, the Honorable Lee H. Hamilton (Member of the Committee) presiding.

Present: Representatives Hamilton and Cox.

Also present: Lee Price, Kenneth Nelson, Edward McGaffigan and Kris Hurley, professional staff members; and Caleb Marshall, Communications Director.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, MEMBER

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order.

Welcome to today's hearing on prospects for Japanese growth in the next decade. The Japanese economy grew at double digit rates in the 1960s. Although Japan's growth rate slowed somewhat in the 1970s and 1980s, it still exceeded the U.S. growth rate by a substantial margin.

As a result, Japan's weight in the world economy grew enormously. This hearing will look beyond the current recession and examine the growth rate that might be expected once the recovery and expansion are established. Some analysts have argued that with its high rates of investment and close ties to the rapidly growing economies of the rest of Asia, Japan will once again enjoy growth in the 4 to 5 percent range over the next decade. Other economists forecast slow growth for Japan because of its aging population and the difficulties in raising productivity for industries at the technological frontier or that have rigid low-productivity institutional arrangements.

Still others point to Japan's past successes in overcoming economic obstacles and predict that Japan will soon be growing as fast as any other advanced industrial country. We have asked our witnesses to provide their own forecasts of Japanese growth in the coming decade and to identify the key factors contributing to faster growth and the barriers causing slower growth over the medium turn.

In addition, we have asked them to consider policy alternatives that might affect the long-term sustainable rate of Japanese growth. We are very fortunate to have three witnesses today who have strong backgrounds for addressing these issues; Arthur Alexander, President of

Japan Economic Insutute; Dick Nanto, head of the Japan Task Force of the Congressional Research Service; and Hiroyuki Tezuka, senior representative of NKK America, Inc. and visiting scholar at The Brookings Institute.

We want to apologize to you for the late start. I think you have been informed that I had a conflict, and as you know, the House goes into session here fairly soon. So what I would like to do is take your statements and put them into the record, and we will proceed immediately to questions, if that is all right with you.

[The prepared statements of Mssrs. Alexander, Nanto and Tezuka start on pp. 15, 23 and 31 of the Submissions for the Record, respectively:]

Representative Hamilton. I know some of this will repeat some of the information that you have in your prepared statements, but that is all right.

First, I would like to get each of you on record with regard to what you see the flight path for the Japanese economy. Is it in the doldrums for a long period of time? Is it going to spurt quickly ahead and be an economic leader as it once was a few years ago? What is the outlook for the Japanese economy?

Mr. Alexander, let's start with you, and we will move across.

RESPONSE OF ARTHUR J. ALEXANDER, PRESIDENT, JAPAN ECONOMIC INSTITUTE OF AMERICA

Mr. Alexander. I see the Japanese economy as slowing down over the next 10 years or so for three main reasons: First, its labor input is declining as the society ages, so there are fewer people to work. Also, the quality of people has plateaued. The education and training levels really has not increased since the 1970s, so the formal qualifications and education of the work force have not increased at all. Second, investment is slowing down, partly because of declining rates of return as Japan became the most capital-intensive economy in the world. Inevitably you slide down your yield curves; you get lower returns from that. But also the financial markets are being deregulated, and the Japanese companies now have to compete on the world stage for funds, and they are being faced with competitive market rates of financial capital.

Third, productivity is slowing down. Past productivity growth partly came from very rapid rates of investment where companies got into the most productive, the newest pieces of equipment. But once you get to have the most productive, the youngest capital stock in the world, you can't do much better than that. The second part of the productivity slowdown is that there are institutions within the Japanese economy that are dragging it down.

So for all those reasons, slowdown of input, slowdown of productivity, and institutions that are dragging down the economy, I see it growing at much slower growth over the next decade or so.

Representative Hamilton. What does that mean, "slower growth"?

Mr. Alexander. Slower growth means down to about 2 percent a year on a real per capita basis—2 percent or less.

Representative Hamilton. You said in your statement, I was quite struck by it, the Japanese economy overall runs only 61 percent of U.S. productivity.

Mr. Alexander. That is right.

Representative Hamilton. So they are not the productivity giants that we often think them to be.

Mr. Alexander. That is right. In certain sectors, they do quite well—automobiles, steel. We have somebody here today from the steel industry who has invested huge amounts in American steel industry. In steel, electronics' productivity is better than in the United States, but these are relatively small sectors.

Representative Hamilton. Why are they so low?

Mr. Alexander. Mainly competition, lack of competition. About 40 to 50 percent of the Japanese economy is regulated; that controls competition. There has also been a pretty weak pro-competition policy.

Representative Hamilton. We know where they are strong. Where are they really weak?

Mr. Alexander. For example, food processing is one industry that many economists have looked at. Productivity is a third of America, and there are more people employed in food processing than in automobiles, automobile parts, steel, electronics and machinery, all put together. They are very poor in services, everything from finance to transportation to trade, retail and wholesale trade. So areas that basically have been protected from both domestic and foreign pressures are also low in productivity.

Representative Hamilton. So if they really wanted to get their productivity up, if you were looking at it from the larger perspective, the thing for them to do would be to focus on the lagging sections.

Mr. Alexander. Exactly. I think to deregulate the lagging sectors, to open them up to domestic and international competition, would be the best thing possible.

Representative Hamilton. Okay. I want to get back to that opening comment in a minute, but, Mr. Nanto, why don't you take off on the original question?

RESPONSE OF DICK K. NANTO, SPECIALIST, JAPAN TASK FORCE, CONGRESSIONAL RESEARCH SERVICE

Mr. Nanto. Yes, thank you. As we at the Congressional Research Service in conjunction with Data Resources, Incorporated have looked at projections for the Japanese economy, we see a recovery occurring late this year and next year, an average of 2.5 percent growth or so in the latter half of the 1990s. Then after that, after the year 2000, dropping to about 2 percent per year.

But that means that Japan still will be the second largest economy in the world—a GNP in the year 2000 of about $6 trillion, two-thirds or so the size of the United States—with per capita GNP of $50,000. Now, of course, Japan has higher prices so the actual purchasing power of that is much less, perhaps 50 percent or less of that in real purchasing power. Japan will become more like the other industrialized countries of the world—Europe and the United States—growing at 2 percent or so and facing some of the same problems.

One of the large differences, however, with Japan, is that they are projected to continue to have a large current account surplus; a surplus rising perhaps from 130 billion this year to 145 billion over the latter half of the 1990s. And that is going to be a large problem that is going to cause more trade friction with other countries of the world.

Representative Hamilton. So the days of the double digit growth and even high single digit growth in Japan are over; is that it?

Mr. Nanto. Yes. About the time that some economists wrote about accelerating growth in Japan, Japan was starting to decelerate. And it is now down to the point where it is having to face the same problems of most industrialized countries.

Representative Hamilton. You don't think then that their record of overcoming past economic obstacles suggests that they will be able to overcome these and return to a strong rate of growth?

Mr. Nanto. Well, in the past they were able to exploit the gap between many industries in Japan and the best practice in the world. Now, there still are gaps in services and agriculture and some of the low-tech manufacturing areas. But those gaps have disappeared in most of the medium- and high-technology industries. And so they are less able to increase productivity through investment, and by buying and importing technology. So their growth rate will be more like the growth rate of any country at the frontier.

Representative Hamilton. How do you think their growth rate is going to compare with the other industrial countries?

Mr. Nanto. It will still be slightly higher. Most of the forecasts are for the U.S. long-term growth rate to be around 2 percent or so. In a good year, we have maybe 3 percent. In a recession, of course, it is lower than that. But Europe also is not growing that quickly.

I don't have the figures for Europe right at my fingertips, but Europe is having some serious problems with growth. Okay, here they are. The European Economic Community, on average, is forecast to rise from 1990 to 1995 by about 1 percent per year, on average; but from 1995 to the year 2000, to rise to about the same as Japan—2 or 3 percent—and then in the year 2000, a little more than 2 percent per year.

Representative Hamilton. Is Japan in a recession today?

Mr. Nanto. They are trying to recover. Now, the recession started in April 1991. The Bank of Japan keeps saying that they are going to recover.

Representative Hamilton. What is their growth rate going to be this year?

Mr. Nanto. This year, it will be around 0.3 percent or so.

Representative Hamilton. So they are still stagnant?

Mr. Nanto. Yes, they are still stagnant; they have been that way.

Representative Hamilton. Are there signs that they are coming out of that pretty solidly, or not?

Mr. Nanto. Recovery is going to be slow. It is going to be much like the United States came out of our recession.

Representative Hamilton. So next year is not going to be too good.

Mr. Nanto. Next year, if things pick up, it could reach 3 percent or so. But it is not going to be the usual growth rate for them, from after a recession of 4 or 5 or 6 percent.

Representative Hamilton. Okay. Mr. Tezuka, why don't you go ahead with that basic question?

RESPONSE OF HIOYUKI TEZUKA, SENIOR REPRESENTATIVE, NKK CORPORATION; AND FORMER VISITING SCHOLAR, THE BROOKINGS INSTITUTION

Mr. Tezuka. I am a professional economist also, but I have a long background in corporate strategies. So I am going to talk from the view of the management of private sectors.

The crash of bubble economy may bring some very tremendous impact on Japanese economy towards the future, because the existence of bubble and asset-based values are the sole source of the Japanese competitiveness in 1980s. The reason is that because of the asset-based inflation, most of the big Japanese companies had their pretty heavy asset base, which can support their investment using the very low or virtually zero cost capitals.

But because of the bubble crash, we lost almost 70 percent of the entire Japanese GNP in 1992. So for the first time after the rapid growth, Japanese management is now facing real cost of capital—a kind of credit crunch. But in the past couple decades, Japanese management has been experienced and has been doing low-risk management, because everyone else is getting free capital—the best solution for management is doing the same things as others. And they invest a lot in domestic production for cities.

So during that period, Japanese management has been losing capitalistic mind. This is going to be a serious problem throughout the next decade, because we are lacking in the capitalist mind, which may generate or should generate the next decade of industries and the business opportunities. But facing with our bubble crash recession, managers are following the traditional Japanese system; that is, following everyone else's strategy.

Representative Hamilton. Excuse me, Japan continuing its very, very high savings rate?

Mr. Tezuka. Yes.

Representative Hamilton. What is happening to those savings?

Mr. Tezuka. Those savings are still pretty high, because everyone in Japan is having a very ambiguous image toward the future. So people are waiting to save more than they spend.

Representative Hamilton. Doesn't that create a lot of pool for investment?

Mr. Tezuka. Yes. But that is the source of money. I am talking about the asset base of individual corporations. Now, big corporations could invest a lot because they had the pretty heavily inflated asset base. That created for them a huge credit try for bank loss. And the banks are very much willing to lend money to those established big corporations where it has a huge asset base with very generous interest rate.

Representative Hamilton. Where do you come down on this question of Japan's future growth? Are these gentlemen right, that it is going to be in the 2, 2.5 percent range?

Mr. Tezuka. Yes. He is talking, Dr. Alexander, from the macroeconomic viewpoint. I am talking from microeconomic viewpoint.

Representative Hamilton. I understand.

Mr. Tezuka. But the conclusion is almost the same.

Representative Hamilton. We don't have any optimists out there this morning. Nobody thinks Japan is going to take off again.

Mr. Tezuka. I do believe that we do have two scenarios. One is continuing the traditional system as long as possible, and losing the possible savings gradually, and getting into the vast negative cycle.

Another scenario is to give up the traditional system and start creating a new system that will be more dynamic. That means give up the asset-based management and get into flow-based management that is focusing on the profit rather than asset creation, and give up keeping the weaker players—that is, weaker industries—or in company unemployment. We have been paying a lot of costs to keep those weaker players in society. And that is going to be the burden to our next decade.

So the choice is whether we are getting into a winner-loser kind of society, or keep-everyone-happy-and-gradually-decreasing-our-wealth kind of a society. I prefer the second scenario, but currently most of our Japanese top executives still believe in the first scenario.

Representative Hamilton. But overall in Japan, we have had in the last several years a decline in the rate of Japanese investment; is that right?

Mr. Tezuka. Yes.

Representative Hamilton. Is that going to continue, are you saying?

Mr. Tezuka. Yes.

Representative Hamilton. Okay. I suppose that is one of the things you factor into your estimates, Dr. Alexander, with regard to productivity?

Mr. Alexander. That is right. I would like to come back to one question that you raised about what happens to all those savings. The savings that are not used in Japan are going on around the world and financing Japan's trade surplus. So as long as we continue to have this gap between the domestic investment requirements and the domestic savings flows, we will have those surpluses that Dick Nanto referred to. As we look to the future, savings is coming down a little bit slower than investment, so we can foresee a surplus for the next several years.

Representative Hamilton. Congressman Cox, please proceed.

Representative Cox. Having come into the middle of this, I am not quite certain where to begin, except that I have been interested in the conversation I have been hearing. I don't want to mispronounce your name, is it Tezuka?

Mr. Tezuka. Yes.

Representative Cox. Mr. Tezuka mentioned in his testimony, and to quote his words, "Huge bad loans that are requiring banks to charge an abnormally high spread between what they pay in savings and what they earned on their loans, that amounting to about 4 to 5 points." I wonder if you could tell us a little bit more about the nature of what you consider to be an impending problem—I take it, one that hasn't been completely realized yet, otherwise people wouldn't be reserving against it. What is the depth of the lending problem nationwide in Japan?

Mr. Tezuka. Most of the bank loans of Japanese financial institutions are backed up by the land asset value. And during the bubble economy, Japanese land asset value escalated almost double and triple. But right after the bubble crash, the whole value decreased by almost 50 or 60 percent. As far as their loans that are creating interest, they would be okay.

But in the back scene, the sound background mortgage ratio is declining a lot. So most of the banks have become very conservative about their lending money policies. So that is going to be a problem for Japanese growth. They are looking after a low risk/high return investment, which is impossible anywhere in the world. But their lending policy is very much conservative right now, and the area of the bad loan is officially announced to be 13.73 on the yen.

This is a Japanese government official announcement. But this is the really, truly bad loans. There are other potential bad loans. That is one private estimation, that a potential bad loan could be somewhere around 63 on the yen, which is far more than the American banks' financial problems in late 1980s and early 1990s.

The American banks have been experiencing tremendous difficulties to write off those bad loans in the past couple of years. So it would take a longer time for Japanese banks to write off. They are not as drastic as the American banks in writing off those bad assets, so it would take a much, much longer time. And this attitude may create a very conservative, entire economic trend in Japan in private sectors.

Representative Cox. I wonder if the rest of the panel would agree with the general assessment that there is a looming—if not a credit crunch—safety and soundness problem for the banking system in Japan.

Mr. Nanto. Yes, the banking system in Japan really is a problem area and one of the reasons that the Japanese economy is going to slow down in the future. They are just not as willing to make loans based on real estate and increases in the stock market as before. One of the indicators of the severeness of this bad loan problem is that I believe it is the Mitsubishi Bank has to report also to the SEC in New York about its bad loans. And the numbers that it reports to the SEC are something like 40 percent higher than those it reports to the Ministry of Finance, because our definition is more strict.

In Japan, for example, I think you have to count something as nonperforming—a loan is nonperforming only after interest payments have not been paid for six months, or something like that. It is a fairly liberal definition.

The other problem is that many of the loans that Japanese banks made, for example to construction companies, are now being questioned because of the scandals in the construction industry. What usually gets the Japanese economy going is construction, public works, things like that. And that is not happening as much now because the banks are less willing to make those loans.

So this is a severe problem that is going to take a long time to work through, as Mr. Tezuka said, in Japan. It is also one that the Ministry of Finance has been taking policies to try and cure.

For example, the Ministry of Finance has funneled Japanese postal savings into the stock market to try and keep the stock market from collapsing so that the banks could keep these assets on their books. Another problem is the Bank of International Settlements requires the 8 percent capital asset ratio, and that is causing problems with Japanese banks trying to meet those ratios.

Representative Cox. Mr. Alexander, do you want to comment?

Mr. Alexander. The whole area of regulation enters in here. American banks have been able to do things like securitize many of their bad or questionable mortgages and sell them. The regulations in Japan have not allowed them to do that, so they are limited by the kinds of things that they can do; they are very limited in how they can deal with it.

Also, we have bank regulations that reduce the amount of competition within the banking sector and between banks and other financial institutions, which reduce the ability to recognize different qualities of risk so that they don't charge more for higher risk loans or higher risk bonds than for low risk ones, which again cripples the financial sector. So we have here customary business practices that are dragging down the system, and we have regulation which is dragging down the system. And both of these things will take years to work off unless we have some major changes in both kinds of practices.

Representative Hamilton. Would the gentleman yield?

Representative Cox. Of course.

Representative Hamilton. What about all this reform going on the political side, how does that impact the prospects for economic growth?

Mr. Alexander. I think the political reform is the most important thing that is happening right now. The changes that we have been talking about that are required are fundamentally political, because there are people there who are benefiting from the status quo and the society as a whole who will gain from major change. What we have seen over the last 10 or 15 years are major shifts in the political weight of different parts of the community.

People have left the farms; they have moved to the cities; they have moved out of the small towns; they have moved out of heavy industry into services. Very little of that has been reflected in politics so far, so there has been a kind of tectonic plate problem here: Major underlying shifts, but without the shaking on the surface that would reflect this.

With the fall of the Liberal Democratic Party Government last year, we are now in the middle of a transition to something new. It will take several years to work its way out, and depending on how that works its way out will determine whether the economy can get on to new ground; whether we will get the deregulation, or get rid of the old habits, or what the Russians call old thinking that is dragging down the system. So I think this is the most critical thing that we are seeing, this political transition.

Representative Hamilton. Thank you to the gentleman for yielding.

Representative Cox. I would like to hone in on the private estimate of 60 trillion yen that Mr. Tezuka referred to. There is a significant spread between the official estimate of 13.7 and this other of 60 trillion, but in either case, we are talking about an enormous number, even for the second largest economy in the world. You suggested that because so much of the lending in Japan is real estate backed, real estate prices will have a big influence on whether or not we actually come face to face with this 60 trillion yen nightmare. What is the prognosis for real estate of the character that is used as mortgage security for loans in Japan?

Mr. Tezuka. I am not a professional financial person.

Mr. Nanto. One thing I might say is that the Japanese Government has a five-year plan. One of the goals of the five-year plan is to have the price of a house equal to, I think, five times income, which is similar to that in the United States. The policy of the Japanese Government is to keep land prices low, and so they are not inclined, I think, to start another bubble where you have this great asset and inflation in land and stock prices.

Representative Cox. So literally, the government policy is working to exacerbate the risk of bad loans?

Mr. Nanto. Well, the government is the one that caused the asset inflation to begin with, so they have tried to correct that. At one point,

land in Japan was so expensive that the value of the Imperial Palace grounds was worth all of Australia. And that was just ridiculous. People could not buy homes; there were complaints about inequities in society between the landowners and the nonlandowners. That was causing tension within society to the point that the government said this is not good either.

Representative Cox. Further evidence of the old truism—location, location, location, I guess.

Mr. Alexander. I would like to add to that a bit. The Japanese Government doesn't speak with one voice, and so we have other parts of the Japanese Government who fear the decline in land values and have been trying to keep it up. And they have been accomplices to the banking and real estate community who are trying to keep the true value of property from appearing on the books—because if they did, the asset base of the companies and the banks would decline. So there has been a kind of double policy here, one of trying to get land prices down to favor the average Japanese person. On the other side, we have sections within the Ministry of Finance who would hate to see that happen because their clients—the banks and financial companies—would suffer. So we have dual policies here, dual voices throughout the government.

Representative Cox. Obviously, the security for the loans is a second order problem. The first order problem is whether they continue to perform, and that directly relates to the current health of the economy. But I am struck by the sheer magnitude of the estimate. How is it that the private estimate to which you referred classifies loans so that they are called troubled loans, or risky loans, or whatever it is that accumulates that 60 trillion yen total?

Mr. Tezuka. As far as I know, the base of that is measuring, as Dr. Nanto mentioned, the difference between the government official announcement and Mitsubishi Bank's statement to the New York Stock Exchange market.

Representative Cox. If that is the case, then the 60 trillion yen number is the real one, and the 13.7 yen number is an artificially low one, and we are left with——

Mr. Tezuka. Not necessarily artificially low, but very much liberal estimation.

Mr. Alexander. As one person from the Bank of Japan said, it is a precise estimate of an arbitrary definition.

Representative Cox. Focusing then on the latter estimate, the private estimate, what causes a loan to make this list? I mean how risky are the loans that are included in that 60 trillion yen total? Is this an imminent failure; is it a watch list? How would you relate it to our U.S. system of classification? Or how would you just explain it in common parlance? What would be the character of a loan that would be included in this estimate?

Mr. Nanto. I think the 60 trillion—actually, I have heard 40 trillion from various sources. That is probably a little more realistic. It is just

that potential, which means that these loans are in trouble. In some cases——

Representative Cox. Are they nonperforming?

Mr. Nanto. Some are nonperforming in the U.S. definition. Some are being restructured. I might add to this that a lot of the foreign investment also is nonperforming. Much of the investment in the United States in real estate, in the U.S. stock market, many of those loans now have turned out to be more than the value of the assets.

Representative Cox. And I take it that this exceptional spread of 4 to 5 points that the banks are charging, again, exacerbates the problem because the ability of a borrower to meet its interest payments is made all the more difficult by the high price they are paying.

Mr. Tezuka. Yes.

Mr. Alexander. This whole problem of the bank loans illustrates a major problem within the Japanese economy, of how the whole banking sector and the financial sector has been tied up in its regulations and, you might say, by attempts by the government to manage the situation. It illustrates also the failures within the Japanese financial system to do things like finance new innovations, to finance start-up companies, to finance the kind of new technology companies that we have in the United States.

So this is illustrative of the broader issues of long-term growth here and the problems of overmanagement, overregulation, of the financial sector in this case, but more broadly throughout the economy.

Representative Cox. Well, I don't mean to press this one point to the exclusion of all others. Access to capital is, of course, at the heart of what each of you has described as the challenge for Japan's future growth. So if we have a built-in major problem with the current system, which is apparently inescapable, it certainly bears our attention.

How might the Government of Japan, whoever runs it in the future, respond to this problem, if in the short term what is done is to temporize and to sweep it under the rug in the ways that you have described? As this problem grows, whether we are admitting it or not, at some point we will come to the juncture where the government has to do something. What is that something likely to be?

Mr. Alexander. Some of the things that have been discussed would involve things like securitizing the loans so that they could be marketed and written down, and yet bring some liquidity to the banking structure. That is one thing. That is now prohibited by regulation.

A second is just simply writing down the loans, recognizing them. Some bureaus within the Ministry of Finance don't like that because it would reduce the taxes the banks would pay, and they want to maintain the revenues, so they don't like the idea of writing off these bad loans. But to get rid of them, to get them behind you and off the balance sheet as quickly as possible, would go a long way to bringing more health into the economy.

Representative Cox. Is the banking structure in Japan sufficiently large to write off 60 trillion yen?

Mr. Alexander. They probably would not have to write off that amount, but some smaller amount. But one of the problems is transparency; we really don't know what the true scale of the problem is. So creating greater transparency into the records of the banking system would also be helpful. Right now, public policy and private decisions are resting on a lack of information. So this is another major shift in what the government could do to help alleviate this problem.

Representative Cox. I take it that at the two ends of the spectrum, we are looking at institutional failure, bank failures, to the extent that the write-offs are that significant, and at the other end, we are looking at a hit to the portfolios of all the investors who may have helped capitalize these banks. And to the extent that bank securities are owned throughout the system, a further depressing effect on everybody's wealth, and thus access to capital.

Mr. Alexander. Yes, right.

Representative Cox. Very gloomy scenario.

Representative Hamilton. We hear a lot about the aging problem in Japan and that is going to have a major impact, is it, on their productivity?

Mr. Alexander. Yes. Several things happen there. As society ages, the more vigorous part of the work force declines. In many ways, the United States has been very lucky in that we have had a very vigorous work force, and it has increased our ability to produce and compete. That is one aspect.

A second is that the savings rate will be declining, and that by the turn of the century some estimates are that those surpluses will disappear. That will inevitably drive up the cost of capital domestically. Even though the markets are now globalized, borders still make a difference, and it is easier to borrow from the bank down the street than from one across the ocean. So interest rates will rise. And third, the price of labor, wages, will inevitably rise in the future as the supply declines.

What I expect to see is that as wage rates rise, profits will be squeezed, and this will drive companies into the market more and more in the future for their funds. So rather than using retained earnings, they will have to go to the market for more of their investment funds, which will make them even more sensitive to their internal rates of return and to the financial cost of capital. So all of these things are happening.

Representative Hamilton. We hear a lot about lifetime employment in Japan, and the seniority wage concepts. Are those institutions, which I gather are very deeply embedded in the Japanese economy, are they just going to simply have to throw those out?

Mr. Alexander. Yes. I think Mr. Tezuka has done a lot of work on this area.

Mr. Tezuka. For a short-term viewpoint, Japanese companies have started giving up the lifetime employment system. But this is because we are facing a recession. But in the long run, I think the lifetime employment system is going to be a problem for Japan's entire economy, because it is the sharing burden by everyone, and we do have our baby boomers in the middle management layer of the corporation. They are between 38 years old and 45 years old. Those people are moving up their career in the next decade and getting much higher wages and the strong seniority base lifetime employment system.

But at the same time, Japanese companies are now facing a strong severe cost competition. So we may not be able to keep this system anyway, regardless whether we are facing recession or not. Also, that system is so much structured into the Japanese society, which means that the young generation may not be able to have real business opportunities or chances to use their skills to show their abilities.

Those new generation people are the potential source of next generation growth. So I think, in the long run, Japanese companies will start introducing the merit-based wage system and also a short time contract-based professional service employment system, combined with some lifetime employment traditional system. That is going to be a transitional period, but on the other hand, I think it is inevitable.

Representative Hamilton. What is the impact for the United States and U.S. policy with a Japan having the kind of economic problems that you are describing? What does it mean for the United States?

Mr. Nanto. I think the largest problem is that Japan is going to have this slower growth with a large trade surplus. And it means that in order to provide concessions on imports, there is going to be direct harm to domestic industries. In the past, Japan could open its markets and everybody could take a share of a larger pie. But when you are not growing anymore, then it is more of a zero sum game in terms of domestic industries. So I think there is going to be a lot more trade friction in the future over access to Japanese markets. And it is not only going to come from the United States, but from other countries in Asia. Japan runs a $77 billion trade surplus with ASEAN, China, Taiwan, Korea and Hong Kong. China, of course, has turned this around by force, brute force, but the other countries are taking fairly aggressive policies to try and turn this around.

Representative Hamilton. The rest of you agree with that, that we are going to have more tensions in the U.S.-Japan trade relationship than we have had in the recent past?

Mr. Alexander. Well, I will agree mainly with what Dick Nanto said, but let me put a little different spin on it. The main direction that Japanese policy is heading today is towards deregulation. This is the byword of all the political parties today. I think, to the degree that that is succeeding, we can help that along.

We have been helping it along with our traditional trade policies of opening up markets. We have done it in area after area to both Ameri-

can and Japanese advantage. To the degree that we can continue to support that kind of development, it will make it easier for American and foreign products, in general, to enter the Japanese market.

It will be good for Japan; it will be good for the rest of the world. So I would see the possibilities of reducing those trade frictions by deregulation, by the opening and liberalization within Japan, that we should be encouraging.

Now, the question is, will it move fast enough? If it moves very slowly, if they become stagnant and this process stops in its tracks, I think the scenario that Dick Nanto mentioned will prevail. However, to the degree that it continues, that the Japanese economy and political system continues to deregulate and open, it will reduce many of the frictions. They clearly recognize that their own internal behavior is creating political problems from the rest of the world. But it is also creating problems domestically, and all the pressures internal and foreign are for it to continue this process of opening. We ought to be helping them do that.

Representative Hamilton. You think there will be a lot more import competition as they open their markets more?

Mr. Alexander. It ought to happen that way, if things go the way we expect. It is hard to imagine deregulating, opening up, liberalizing, without there being more import competition. If we just look at sectors like retail trade, there are companies around the world dying to get into that market, who have methods of organizing business practices that far surpass what we see in Japan today; these are not only American companies like Wal-Mart or Toys "R" Us, but European companies like IKEA who could come in and transform the retail sector. And I expect some of this to happen. We are already beginning to see it happen.

Representative Hamilton. Well, I have a lot of things I would like to go over with you, but unfortunately I have to leave at this moment to go on to some other matters. I regret that we haven't had more time, but I think we have had a good discussion in the few minutes we have had, and your excellent statements will certainly contribute to our understanding of the Japanese economy and its prospects for growth in the next decade.

Thank you very, very much. There are too many things going on here, so we stand adjourned. Thank you.

[Whereupon, at 10:41 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF MR. ALEXANDER[1]

Abstract: The Japanese economic miracle has been over since the early 1970s. From 10 percent real annual per capita growth rate of gross national product between 1955 and 1970, Japan's economy slowed to 3 percent growth in the next fifteen years. The 1990s and beyond are likely to witness further declines because the sources of earlier growth—investment, increases in labor supply, and productivity growth—are drying up. Higher productivity is key because it allows greater outputs from the same inputs, higher personal income, superior products, more convenience, and additional leisure; higher productivity also makes business more competitive by reducing costs and improving products.

Political choices in the future will determine whether Japan's maturity will be vigorous or stagnant. Many of the very policies and behavior linked to Japan's post-World War II economic success could endanger its transformation into a successful twenty-first century society if left unchanged.

THE MATURING JAPANESE ECONOMY

Introduction. Japan's economic performance since 1945 has been nothing less than extraordinary. It has demonstrated rapid growth, vigorous productivity improvements, strong export performance, and rising incomes. Japan has been a role model to other developing countries who have seen that the path to modernization and improved economic welfare is open to peoples of all continents, not just to Europeans and North Americans. Even in its excesses, Japan has been extraordinary. Its trade surpluses of the last 15 years have transformed it from a debtor country to the world's largest creditor. Japan's bubble economy of the late 1980s created a property and stock market boom that startled anyone calculating the price of a square meter of land in the Ginza or the market value of the Tokyo Stock Exchange. The domestic and international investment bonanza accompanying the bubble promoted its own glut of books and analyses proclaiming the rise of a new economic superpower based on the launching pad of Japan's enormous investments in plant and equipment, in R&D, and in foreign acquisitions.

The bubble burst, as bubbles inevitably do, and the Japanese economy is now at the bottom of its worst recession since 1945. The returns to those investments made only five or six years ago seem to have turned mainly negative. Renowned institutions such as lifetime employment are crumbling. A recurring question is whether there is a permanent change in the works or whether the Japanese economy will bounce back to its 100-year trend of extraordinary growth.

The short answer is that Japan is undergoing a permanent transformation into a regular economy. Economic growth can come from increases in the physical capital stock, from improvements in human capital, from growth of labor inputs, or from productivity improvements in the use of inputs. All of these sources of growth are slowing down. Japan is no longer small and backward and catching up, but large and mature and a major player on the global

[1] The Japan Economic Institute is partially supported by Japan's Ministry of Foreign Affairs. This statement is the result of the author's research and analysis; the views expressed here are not necessarily shared by JEI or its sponsors.

stage. Many of the institutions and practices appropriate to a developing economy no longer work in a regular country. Even worse, the rules of thumb and routines mastered so laboriously over the past 45 years may retard further progress.

The drama, though, is still unfolding. Japan is not the first nation to attempt the transition from underdevelopment to maturity. Brazil and Argentina, for example, have been attempting this move for 75 years, but the beneficiaries of the status quo and others who perceived harm from change thwarted the necessary policies. Such changes require great political and economic adaptation, which though already begun in Japan is still in the early stages. Since the 1860s, that country has shown a huge competence to transform itself, but the past is not necessarily prologue of things to come. The drama should be absorbing and enlightening, both to the participants and to the audience, who will themselves be caught up as supporting players.

Declining Returns to Investment. Economists have long recognized the possibility of economic stagnation as the returns to investment decline with the increasing capital intensity of production. Japan's economic growth, in particular, is susceptible to that prospect since it was driven by high rates of business investment: in the 1960s, for example, more than one out of every five yen of output was plowed back into equipment investment. As the capital intensity of Japanese production overtook the levels of the United States and other advanced industrial economies, the nation's industries earned ever lower returns on their investments; economists estimated that the 1990 marginal returns to capital investment in Japan were about one-third less than in the United States. The Economist magazine reports that post-tax profit as a percentage of equity capital of firms listed on the Tokyo Stock Exchange is only 2.5 percent, compared with rates of 8 percent to 16 percent for Germany, France, Britain, Singapore, Hong Kong, and the United States.

Business Investment Shrinking. Prior to the 1980s, the government channeled high domestic savings to favored industries through regulated financial institutions, which provided a below-market cost of funds to many Japanese manufacturing firms. Now, however, Japanese companies must pay competitive global rates because of financial market liberalization and globalization. In contrast to the time when companies could rely on large profits or low interest rates, they now will have to make investment decisions balancing real financial costs against declining investment returns. This changing financial reality will require shifting business strategy from growth to profits. In the first half of the 1980s, before the unsustainable investment boom later in the decade, plant and equipment investment already had fallen to 15 percent of GNP from the high-growth era of rates topping 20 percent. The future will likely see this downward trend continue.

Declining Investment and the Current Recession. Investment is the link between the short run and the long run. Not only does investment provide the productive base for the future, it also adds to current demand and thereby stimulates the economy. When plant and equipment investment surged to more than 20 percent of GNP in 1990 from 15 percent just a few years earlier, many Japanese observers proclaimed the return of the good old days. However, the subsequent collapse of business investment was a major contributor to recession, which will continue until demand rises to the level of productive capacity. Equilibrium is likely to be reached at investment-to-GNP ratios of around 14 percent, or possibly even lower. The implication of permanently lower rates of investment is that this old locomotive of growth is slowing down. Whereas Japan used to pride itself on its "growth" recessions during which GNP continued an upward trend, the future is more likely to see recessions where growth

turns negative. The current economic slowdown is Japan's first "regular" recession with real (though, modest) declines in GNP not caused by uncontrollable external events like energy price shocks.

Stagnant Investment in Human Capital. Investment in education, which complements investments in physical capital, reached a plateau in the 1970s with almost 100 percent literacy and a large proportion of the population completing high-quality secondary education. The average level of formal education barely has changed since then. The gains from further extensions of educational attainment will have to come primarily from increasing the caliber of university education as well as the share of people with university degrees, which now is almost 30 percent below the American level for 22-year-olds. Impending labor shortages and a shift to electronics technologies in manufacturing and services could increase the demand for more educated employees to help offset higher real wages and to operate the more complex technology; this change in the demand for educated workers has been witnessed in the United States since the 1970s.

Shrinking Labor Force, Demographic shifts in Japan will cause the labor force to decline in the late 1990s. As wages rise due to the falling labor supply, more older people and women will be drawn into the labor force, which will mitigate somewhat the shortage. Nevertheless, higher wages could raise the cost of output in Japan and erode the share of income going to profits, which—in turn—would further reduce the internal company funds available for investment.

THE PROBLEM OF LOW PRODUCTIVITY

Productivity and Investment Linkages. Productivity growth and investment are related because new equipment typically includes the most advanced capabilities. As investment falls, productivity growth from this source is likely to shrink. Another retarding factor is that countries gain an extra boost from their investment when they are technological laggards. Japan's manufacturing productivity seemed to have stopped benefiting from the laggard effect in the 1970s when its capital stock was the youngest of the industrial countries.

The Productivity Puzzle. Productivity gains among mature economies, however, need not go to zero. Over the twenty-year period to 1989, the so-called total factor productivity (which accounts for the contributions of all inputs) of the ten industrial countries with the highest per capita incomes increased at annual rates of 1 to 2 percent. Although explanations for this growth and its variations are not fully satisfactory, international openness and competition, R&D (especially basic research), and the adaptability of the economy seem to be the key ingredients for success of the mature economy. Japan's prospects in these areas are mixed.

R&D Quantity and Quality. Japan's R&D system, mainly financed by the private sector, was widely and correctly regarded as a model of effectiveness because of its close attention to the objective of profitability rather than the technological choices of government bureaucrats; now, that same system is rightly criticized for insufficient support of basic research, which many studies have shown to be the source of tomorrow's innovations and industries. Several indicators place Japan's R&D efforts ahead of the United States; for example, the ratio of research scientists and engineers to the labor force was 17 percent higher in Japan than in the United States in 1989 and the ratio of R&D to sales has been higher for several years. The absolute scale of American research is much larger than Japan's; U.S. expenditures on R&D and the total number of scientists are both about twice as great as Japan's. Moreover, Japan is relatively weak in basic research, which seems to have several times more impact on

productivity than either physical investment or applied research. For example, American authors turned out more than 35 percent of the world's scientific and research literature in 1991 versus 8.5 percent for Japanese scientists, a difference that is twice as large as would be expected on the basis of expenditures.

Competition and Productivity. Cross-country studies of productivity conclude that variations in the intensity of competition faced by managers and their exposure to producers on the leading edge are the factors most closely linked to productivity leadership. For example, Japanese productivity in motor vehicles, automotive parts, steel, consumer electronics, and machine and precision tools were all above American levels in 1990. These industries faced high levels of domestic or international competition and were challenged to come up with better ways of making things while adopting the best practices of others. One of the outstanding innovations of the 20th century, the Toyota production system, came out of this experience.

Low Average Productivity in Japan. On average, though, Japanese manufacturing productivity is only 80 percent of the American level. The partially regulated food processing business, for example, was two-thirds below American levels in 1990; this industry employed more people than steel, vehicles, automotive parts, and machine and precision tools combined. Japanese economy-wide productivity was even lower than the manufacturing figures; gross domestic product per employee in the market sector, which accounted for 81 percent of GDP and 87 percent of employment in 1990, was only 61 percent of the American value and fell below the levels of France, Germany, and the United Kingdom.

The Impact of Regulation. The principal reason for lagging sectors and firms in Japan is overt regulation or other forms of noncompetitive behavior condoned and sanctioned by government, either through formal laws and regulations or through informal and customary practice. Many of these practices were established for sound regulatory reasons: for example, to protect the public from financial instability in the case of banking and insurance; to guard against unsafe products in the case of numerous specification requirements; or to control the prices of monopoly producers in the case of telecommunications and transport. In other instances, regulation was explicitly designed to protect important political supporters: agriculture and small-scale retailing are examples. According to Japanese government estimates, approximately 40 percent of the economy is subject to explicit regulation. Regulatory constraints are retarding Japanese innovation in several of the most dynamic new industries such as multimedia, which combines telecommunications, computing, and the broadcast media. Without significant deregulation, Japanese participation in these emerging industries will be thwarted.

PRESSURES FOR CHANGE

Deregulatory Pressures. The negative side-effects of regulations intended to protect the public or support industrial growth became more apparent as economic growth slowed and as millions of Japanese who traveled abroad each year could see directly that other policies were both feasible and desirable. Additional pressures for change come from Japan's internationally competitive businesses whose efficiency is dragged down by their inefficient domestic suppliers. The international community is also urging Japan to continue the deregulation and market-opening process initiated in the 1970s. Foreign companies that believe they could be profitable in more open and less regulated Japanese markets are pressuring their governments, which need little additional encouragement, to negotiate market-opening arrangements.

Economic and Demographic Forces for Change. Slower economic growth and rates of productivity improvement combined with significant lags in productivity levels are combining with other forces to bring considerable pressure for change. The Japanese people are more likely in the future than in the past to question policies that have favored the narrow interests of producers and the special interests of politically favored groups over those of individuals. The pressure for change arises in part from demographic and economic changes. Relatively fewer people work in the formerly favored sectors. Manufacturing employment fell from a 1970s high of almost 30 percent of all worker to 24 percent in 1991; heavy industries such as steel and petroleum products lost more than one- third of their employees. Services (including transport, communications, wholesale and retail trade, finance, insurance, real estate, government, and other services) rose from 40 percent to 60 percent of the labor force between 1960 and 1991. Over these same years, agricultural employment fell by more than 10 million—from 30 percent of the labor force to 6 percent. From 1966 to 1991, the number of small retail shops fell by 22 percent and employed 430,000 fewer people while the economy as a whole grew by 400 percent. The inhabitants of smaller towns and villages fell from 36 percent to 23 percent of total population. All of these trends are continuing.

Political Inertia. Despite these substantial shifts, politics remained straitjacketed. Incomplete adjustment of legislative districts over the postwar period gradually brought about rural overrepresentation in the national parliament by more than three to one over urban districts. The political alignments that brought the Liberal-Democratic Party to power in 1955 managed to hold the reins of government until 1993. During this period, government policy favored producers (especially heavy industry), agriculture, small shopkeepers, and small-town and rural interests.

The Political Battle Over Change. Economists in the 1950s came up with the idea of the Turnpike Theorem. (Now it would be called the Freeway Theorem.) Under certain conditions, they argued, it could make sense for a nation to reconfigure its economic structure to emphasize rapid investment and growth of production while sacrificing current consumption. In effect, the nation would take a detour from its current development path to get on the turnpike, zoom along at high speed, and then exit onto the road of high consumption. Japan's economic development was the embodiment of the turnpike theory. What economists did not foresee was that the turnpike to growth could become a treadmill to nowhere, with all exit ramps blocked by political barriers protecting the status quo.

Change in Japan will therefore be profoundly political. Many beneficiaries of the status quo will fight deregulation and pro-competition policies. Inefficient firms, workers facing job loss, cities and regions confronting decline, and government ministries giving up their authority all face real losses. Other political forces, though, push in the opposite direction. Political reforms passed in 1994 under the first non-Liberal-Democratic Party administration in 38 years should go a long way to begin shifting the balance of legislative influence in favor of urban and consumer interests and away from the traditional supporters of the old power structure.

SOME EFFECTS OF CHANGE

Japan's Future Trade Surplus. If an economy's total consumption—household, business, and government—is greater than aggregate production, it will necessarily have a trade deficit with the rest of the world. Another way of stating this proposition is that an economy with an external deficit overconsumes and undersaves. In contrast, a country like Japan with a perennial

surplus has net saving; that is, saving is greater than the domestic investment it usually finances. Therefore the key to projecting trade surpluses over the long run is to consider the balance between saving and investment. It was noted above that business investment is likely to fall. Household saving is also likely to decline as the society ages and more people retire from the active labor force. Government surpluses, too, will probably disappear as transfer payments to older citizens rise to cover social security payments and medical care costs. (The government is currently running a small recession-created deficit, although it still has a structural surplus.) Since both saving and investment will be falling, the difference between these accounts, which determine net trade flows, is difficult to forecast with precision. It seems probable that business investment will fall earlier than will government and household saving, implying that Japan will continue to oversave for some years. Over the longer run, however, this trend most likely will come to an end as the declining saving behavior kicks in with full force. Several projections place this shift near the turn of the century. Therefore, Japan's surplus with the rest of the world has a few more years to run.

The Crumbling of Customary Business Practices. Slower economic growth is transforming customary economic relations. The pattern of lifetime employment, which made sense when growth was rapid, has been fading since the 1970s slowdown; its erosion will accelerate in the coming decade. Its passing, though, will not have entirely negative consequences for business. Lifetime employment bred a close alliance between employee and company, promoted training and personal development, and motivated managers to outstanding levels of effort, but it also encouraged conservative decisionmaking and stifled innovation. Since Japanese management in the coming decades will be facing the new challenges of adaptability in face of rapid change, the selection and promotion methods established in the high growth period could be dysfunctional.

Another Japanese business custom, high levels of corporate cross-shareholding, was an effective tool against takeovers as well as a method of cementing long-term relations. This type of mutual investment also was good for the bottom line and the balance sheet when profits were perpetually rocketing upward. Now, however, it is becoming a more costly practice when capital has to be raised in competitive markets and profits grow more slowly. Similarly, the deep pockets of *keiretsu*—the large vertical or horizontal groupings of companies either in the same business or affiliated with a corporate family bank—will not be as deep as they once were and likely will be less able to sustain unprofitable diversifications and ward off acquisitions and mergers. Therefore, we are likely to see more unfriendly business acquisitions—both domestic and foreign.

The Role of Women. Labor market shortages could have significant consequences for the role of women in society. Women are the great underused resource in Japan's economic life. Only very slow progress has been made by women in penetrating the upper levels of management and technical jobs. Higher labor costs and the gradual decay of the rigid lifetime employment system will aid in prying open opportunities for women. Already more women are attending four-year universities than previously, although their proportion is lower than that of men, which is the reverse of American experience. Also, women's age of marriage is on the rise as they take more time to try their hands at careers. However, sociologists suggest that changes in the attitudes of men and women toward work and family roles probably will be quite slow. Substantial change is only likely as new groups of both men and women move through gradually shifting work and home patterns. Economic forces could

take a long time to alter traditional Japanese gender roles, although the direction of change is for fuller participation by women in the work of the nation.

The Potential Gains From Catching Up. If Japan takes the necessary steps to deregulate its economy and fully open itself to foreign competition and investment, the gains as well as the required adjustments could be substantial. The average productivity of Japan's market economy is 60 percent of the American level. If the productivity of this sector rose to the 1990 U.S. level, 40 percent of the affected work force could be released for more productive activities.[2] A transition to America's 1990 productivity level over a 20-year period would be equivalent to a 2.6 percent annual productivity growth rate in the market sector, which is 87 percent of the total economy; at the same time, such a transformation would create redundancies amounting to 1.75 percent of today's 65-million workers or more than one million people annually. *The central question about the future of the Japanese economy is whether it is sufficiently adaptable to absorb such changes.*

If Japan makes the correct policy choices to boost productivity, its economy could well continue to out-perform those of other advanced countries. Conversely, if no changes in regulation, education, R&D, the role of women, etc. are made, it could become a perennial under-performer inasmuch as its existing regulations and institutions are outmoded for an advanced, mature, large economy.

IMPLICATIONS FOR THE UNITED STATES

Competition and collusion. The Japanese economy contains many paradoxes for American observers, chief among them being the coexistence of cut-throat competition together with protection, regulation, and collusive relations within the business community and between business and government. Japan's most successful industries on the world stage were bred in a hotbed of domestic competition, often while protected from foreign dominance. The first few decades of the postwar period witnessed the emergence of entrepreneurial firms such as Sony and the development of one of the most important innovations of the 20th century in the Toyota system of production. It must be acknowledged, even by an economist, that government played a vital and creative role in these developments.

Foreign frustrations over collusive behavior. However, as the Japanese economy matured, the interplay of government authority, regulation, weak competition policy, and money politics created multiple webs of collusion protecting business from the full blast of competition. Foreign frustrations over the difficulty of breaking into Japanese markets and the frequent complaints of "unfair practices" and "unlevel playing fields" seem largely to have resulted from this collusive behavior. These complaints grew more numerous while Japan was in fact beginning to dismantle many of its regulatory restrictions in the 1980s and while American exports to Japan grew faster than the U.S. economy and faster than total trade.

At the same time, American government negotiations with Japan to open specific markets and to promote domestic and international competition often dragged on for years without any apparent success. Despite the frustrations produced by seemingly endless rounds of negotiations, measurable results flowed from these efforts. A Congressional Research Service study covering 60 products subject to negotiation between 1985 and 1992 shows that exports

[2] To say that Japan is only 60 percent as productive means that it requires 167 people to produce the same output as 100 people in the U.S. The redundant 67 Japanese workers are 40 percent of the market economy's work force.

of these products rose twice as fast as total U.S. exports to Japan or to the rest of the world.

American Policy. Vigorous economic growth for Japan will require unraveling these collusive webs through deregulation, strong pro-competition policy, and political reforms that break the powerful links between politicians and business. Such policies would benefit Japan as a whole. They would also contribute to American welfare and to the broader international community by opening the Japanese economy to greater foreign participation while reducing the corrosive trade frictions between Japan and its trading partners.

The United States can support such positive developments by orienting its policies toward Japan to support greater openness, deregulation, and other measures that curb the interventionist habits of the Japanese government and the cartelization preferences of Japanese industry. In the absence of such a strategy, the U.S. is liable to throw its weight behind policies that promote short-term goals but that may also undermine its own long-term interests. One example of such a policy was the 1986 semiconductor agreement according to which 20 percent of the Japanese market was expected to be gained by American producers by 1991. A Japanese government official described this agreement as equivalent to placing a glass of whiskey in front of a reforming drunk; the Ministry of International Trade and Industry, despite its attempts to swear off its interventionist habits, could not resist the temptation of coordinating the industry response through guidance, pleading, and outright threats. Although this agreement may have helped expand a particular market for American companies, it also played into the hands of those Japanese trying to preserve the status quo.

Indeed, American trade policy toward Japan over the past 25 years, by and large, has been allied with domestic Japanese moves toward deregulation and openness. In the current Japanese environment, the pressures for significant improvements in economics and politics are beginning to produce real results. However, without foreign involvement, some of these policy outcomes may be considerably delayed and others may be resolved in ways that depart from U.S. interests. It is therefore useful for American policymakers to search for natural alignments of interests and to stimulate these when they occur. In any event, both the United States and Japan will be better served by American policies that promote the goal of making Japan a more productive, more stable, and more open nation than by policies that give more weight to the past.

PREPARED STATEMENT OF MR. NANTO

In 1995, Japan will mark the half century mark since its surrender on the deck of the USS Missouri at the end of World War II. In the year 2002, Japan will celebrate the fiftieth anniversary of the signing of the San Francisco Peace Treaty that ended the Allied occupation of Japan and marked that nation's emergence into the world as a country that essentially rewrote the book on economic development. The lesson of the twentieth century, that other nations in Asia are emulating, is that Japan gained in peace what it failed to gain in war.

Now Japan appears to have fallen into relative chaos. Its economy is in recession. The country has greeted its first Socialist Prime Minister in more than 40 years. Banks are burdened with nonperforming assets that neither they nor the government wants to acknowledge, and manufacturers are scrambling to turn a profit. Japanese investors who snapped up American stocks, companies, buildings, and real estate in the 1980s now find the value of those assets sinking even more rapidly with each downtick in the value of the dollar.

The question is whether the Japanese sun is setting or merely passing behind a cloud. How will Japan change, and what do those changes imply for U.S. policy over the next decade?

A MACROECONOMIC FORECAST

In the year 2000, Japan's economy will likely have most of the same contours that it has today, but it will differ in many of its important respects. The changes will be on both the macro and micro sides of the economy.

GROWTH RATES

In terms of macroeconomics, the medium-term outlook for Japan is, well, medium. According to forecasts by DRI/McGraw-Hill and others, Japan's economy should recover from its current recession[1] and achieve growth rates in the neighborhood of 2 to 3 percent per year in the second half of the 1990s.[2] Growth is forecast to average 2.5 percent for 1995-2000 and then drop to about 2 percent for the next decade. The growth rates for 1995-2000 depend partly on how quickly and how strongly the nation recovers from its current recession which began in April 1991.

Compared with the double-digit growth rates of the 1960s and the 4 to 5 percent growth rates of the 1970s and 1980s, these growth rates are relatively low but slightly higher than those DRI/McGraw-Hill expects for the United States. In short, Japan's has become just another industrialized country that is growing fast enough to keep ahead of a rising labor force but not fast enough to perform any miracles.

At these growth rates, Japan will continue to be the second largest economy in the world. Currently, its gross domestic product at $4.3 trillion is about two- thirds the size of that of the United States ($7.3 trillion) and larger than Germany, France, and the United Kingdom combined. Since prices are higher in Japan, the domestic purchasing power of their GDP is only about $2.5 trillion. By the year 2000, Japan's GDP is likely to exceed $6 trillion at nominal exchange rates.

[1] Sato, Masaru. Japan Economic Upturn Promised, But Yen Fears Stay. Reuters News Service. July 20, 1994.

[2] Forecasts in this report are based on the DRI/McGraw-Hill Japan model. Forecasts were provided directly by DRI/McGraw-Hill, but most are summarized in: DRI/McGraw-Hill. *World Markets, Executive Overview,* First Quarter 1994. Lexington, MA, DRI/McGraw-Hill. p. 51ff.

In terms of GDP per capita, at current exchange rates, Japan's $34,000 exceeds the American $26,000, although at purchasing power parity rates (adjusting for higher prices in Japan), it is considerably less ($20,000). Since Japan's population is growing slowly (less than half a percent per year), most of the increase in its GDP will raise GDP per capita. By the year 2000, Japan's per capita GDP will likely be around $50,000.

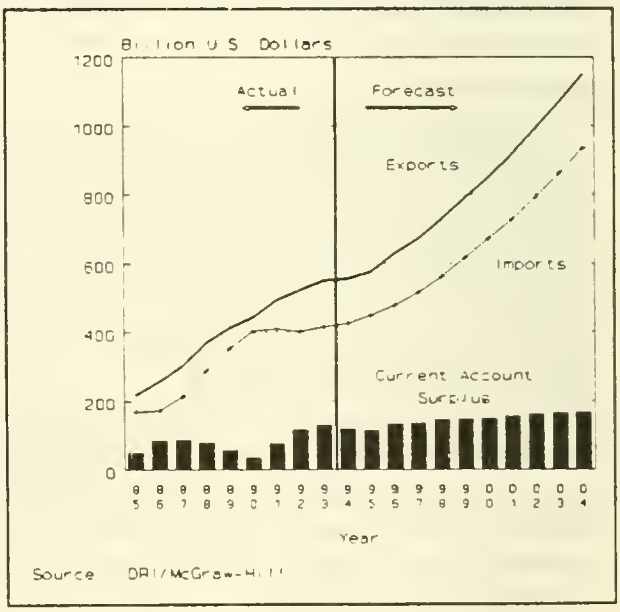
The Japanese consumer market already is rich and likely will become even more so in the next century. It is a market that should continue to receive high priority both in U.S. economic policy and American business strategy.

TRADE AND EXCHANGE RATES

What effect will the slower growth in Japan have on its external balances? Japan's current account surplus (trade with the world in goods, services, plus unilateral transfers) at $130 billion in 1994 is forecast to rise to about $145 billion in the year 2000 and stay above that level for the next five years. (See figure 1.) As a percent of Japan's GDP, DRI/McGraw-Hill forecasts the current account surplus to decline from its peak of 3.2 percent in 1992 to about 2.5 percent for the rest of the 1990s and then to roughly 2.0 percent by 2005.

Under the ongoing U.S.-Japan Framework Talks, Japan agreed to take fiscal and monetary measures to achieve "a highly significant decrease" in its current account surplus. Some observers considered this to mean a reduction to 2 percent of GDP over the medium-term. This forecast indicates that such a reduction is not likely to be achieved for perhaps a decade or more unless the Japanese government changes its economic policies or the economy shifts in ways not anticipated by the forecasters.

FIGURE 1. Japan's Total Exports and Imports of Goods and Services and Current Account Surplus, 1985-2004



Most of the continued large surplus in Japan's current account stems from the stagnation in imports into Japan over the past three years. Between 1990 and 1993, Japan's current account surplus jumped from $36 billion to $131 billion primarily because imports into Japan slumped with the bursting of its so-called bubble economy of the late 1980s and the ensuing recession. As the economy slowed, imports stagnated, particularly of foreign luxury goods. Even though growth in imports is forecast by DRI/McGraw-Hill to keep pace with the growth in exports over the next decade, the rise in imports is not likely to be fast enough to close the gap with exports.

This forecast, however, assumes only moderate appreciation of the yen over the next decade. It is based on a yen-dollar exchange rate of 98 yen per dollar in the year 2000 and 91 yen per dollar in the year 2004. Recent strength in the yen, however, already has pushed the exchange rate below 100 yen per dollar. If the yen continues to strengthen, Japan's current account surplus could decline fairly rapidly over the next decade.

The exchange rate that equalizes purchasing power for a basket of goods between the United States and Japan was variously estimated in 1993 to be from 160 to 187 yen per dollar.[3] This implies that Japan's exports carry the equivalent of a 60 to 87 percent surcharge.

The appreciation of the yen from and exchange value of 145 yen per dollar in 1990, to 127 in 1992, to 111 in 1993 and a current rate of 99 yen per dollar in July 1994 has had a powerful negative effect on Japanese exporters. For a product with a price of $100 in 1990, the exporter had to charge $146 in 1994 to generate the same amount of yen. If course, the higher yen also reduces the import prices of goods and services that Japan imports, particularly those of raw materials. But the major effect is to force their exporters to raise prices of products in foreign markets.

According to a recent Japanese government survey, at 117 yen per dollar, about a third of Japan's exporters can break even. At 105 yen, less than 6 percent of companies cover costs, and at 100 yen per dollar, less than 1 percent can break even.[4] According to this survey, therefore, 99 percent of Japan's export industries cannot break even on exports at current exchange rates, let alone make a profit.

If one looks back over the history of the appreciation of the yen, however, it shows that Japanese businesses have adjusted remarkably to each strengthening of the currency. The break-even point keeps coming down. In 1986, when the yen was 205 per dollar, the break-even rate was 210 yen per dollar. In 1990, when the yen was 150, break-even was 140 yen per dollar. Japan's exporters keep lowering their costs of production. They have had to adjust. Those that do not are being forced out of foreign markets.

If Japanese government policies do not bring more balance into Japan's current account, the yen is likely to appreciate even more and Japan's industries will face even greater competition both at home and in foreign markets. Government intervention can slow the process but not reverse it. Since first quarter 1993, the Japanese government increased its foreign exchange holdings by about $50 billion to the point where its reserves ($112 billion) now exceed those of Taiwan. Even the Bank of Japan, however, cannot keep intervening by buying dollars forever.

The next decade, therefore, is likely to be difficult for Japan. Its growth is likely to slow to the level of other industrialized nations, but its current account is likely to remain in surplus. This means that pressures on Japan to provide greater access to its markets will continue, but given the slower expansion of the domestic market, there will be less leeway for imports to expand without hurting domestic industries. The Japanese government is likely to face strong resistance to trade liberalization and deregulation from businesses who are benefiting from existing restrictions.

In terms of implications for U.S. policy, trade negotiations will continue to be difficult. The opportunities for competitive U.S. industries to expand in the Japanese market, however, should be numerous. The high yen is creating interests in Japan who favor many of the market opening measures being pursued by U.S. negotiators.

U.S. requests for deregulation of Japanese businesses also are likely to find allies in Japan. Although entrenched companies (particularly in financial sectors that have been hard hit by the current recession) are likely to remain opposed to new entrants, others are likely to develop interests in deregulation.

[3] The 160 yen per dollar rate is the U.S. Central Intelligence Agency's. The rate of 186.7 is DRI/McGraw-Hill's rate for 1993.

[4] Koll, Jesper. S.G. Warburg Securities Morning Note. May 6, 1994. p. 1.

The Japanese government, itself, has estimated that deregulation could add as much as a half of a percentage point to Japan's growth rate.[5]

MICROECONOMIC CHANGES

The above macroeconomic forecast underscores the point that over the next decade, Japan is likely to be similar in many respects to what it is today. Underlying the macroeconomic outlook, however, are numerous microeconomic changes that are likely to have significant and far reaching effects on life and business activity in that country.

It is difficult for any nation to overcome the inertia of the status quo and change, but change is being forced on the Japanese. Change is stemming from two primary forces: those that pull and those that push.

Forces that pull originate from a gap between one state and another, be it existing or envisaged, and actors who work to close that gap. They pull the status quo into change. In Japan's case, the primary pull factor was the prospect of catching up with the more industrialized world. There was the allure of Western income levels, standard of living, technology, business profits, and potential markets. Japanese planners could envisage where the nation needed to go because they could see precisely where the advanced countries, like the United States, were. Much of Japan's development in the postwar period was a process of pulling up industries, one by one, to the level of those in the United States and Europe.

Change also occurs because of push. Economies and the actors within them change because they are forced to do so. They are pushed in much the same way that refugees flee social and political unrest. They either move or face elimination. In Japan today, significant push factors include: low domestic growth, stagnant markets, low profitability, the high value of the yen, import competition, greater consumer price consciousness, deregulation, and a growing surplus of white collar workers in companies that value lifetime employment.

Among these push factors, the greatest currently seems to be the rising value of the yen along with soaring costs of production. Wages have been rising. In 1975, Japan hourly compensation costs for production workers in manufacturing was $2.25 as compared with $6.36 in the United States. By 1992, Japan's had risen to $16.16 as compared to $16.17 in the United States.[6] Over the next decade, Japan's wages are expected to continue to rise relative to those in the United States. Japanese manufacturers, therefore, appear to be going through an adjustment process that resembles the experience of the United States during the first half of the 1980s. Companies are restructuring and rationalizing their production—including moving some manufacturing offshore.

INDUSTRIAL TRANSFORMATION

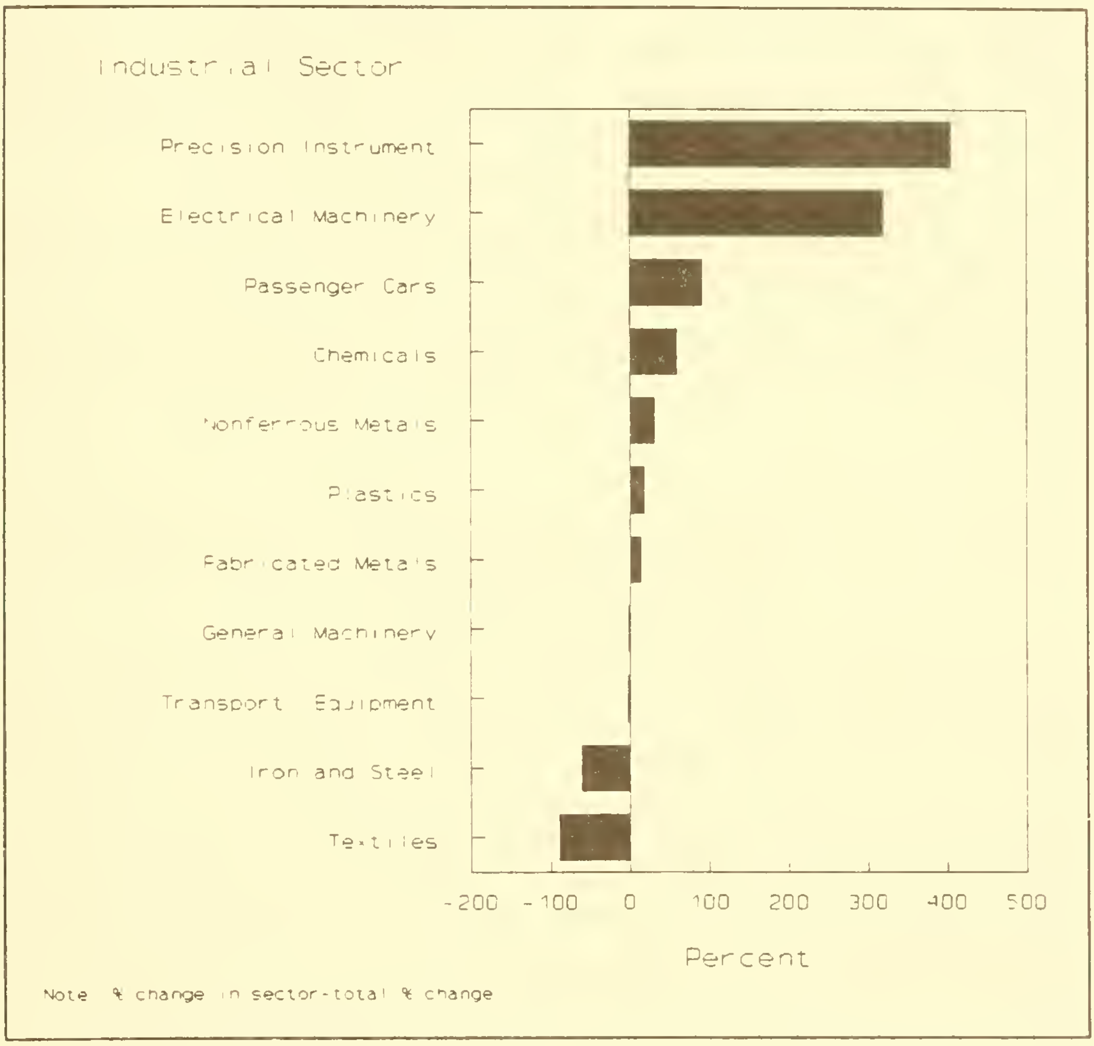
In essence, Japan has become a relatively expensive place to manufacture products, particularly for sale abroad. This has caused a transformation of the economy from one dominated by industries making textiles, toys, and TV sets to one producing cars, communications equipment, and computer components.

[5] *GDP 0.5% Pointo Age* (GDP 0.5% point up). *Nihon Keizai Shimbun*, July 17, 1994. p. 1.

[6] U.S. Bureau of Labor Statistics. Office of Productivity and Technology. Hourly Compensation Costs for Production Workers in Manufacturing (Unpublished data). March 1993.

Figure 2 shows the relative change in production from 1973 to 1992 for certain major manufacturing industries in Japan. The data show the percentage change in the production index for each industry minus the percentage change in the production index for all industries (68 percent). This shows how much more or how much less industrial production in each sector grew (in absolute percentage points) when compared with the 68 percent increase in all industrial production.[7]

FIGURE 2. Relative Change in Indexes of Production in Industrial Sectors in Japan, 1973-92 (Percentage change in production in sector minus percentage change in all manufacturing)



[7] The value of 405 for precision instruments indicates that the production index for that sector rose by 405 + 68 or 473 percent. The value of -62 for iron and steel indicates that the production index for that sector rose by -62 + 68 or 6 percent.

As might be expected, the greatest relative growth in Japan occurred in high- and medium-technology industries such as precision instruments, electrical machinery, and passenger cars.[8] Growth also was strong in chemicals, a sector that is considered to be fairly uncompetitive at current exchange rates, and nonferrous metals.

Sectors that grew at a rates close to the average were plastics, fabricated metals, general machinery, and transport equipment (growth in car production was offset by a decline in shipbuilding). Sectors that declined in relative terms were iron and steel and textiles.

The shift away from traditional industries such as apparel or iron and steel will likely continue in Japan over the medium term. Rising exports of light manufactures from the newly industrialized and emerging nations of Asia (some from Japanese subsidiaries) along with the development of heavy industry in countries like South Korea pose strong competitive threats to Japan's domestic factories. Even Japan's automobile companies are test-buying products, such a galvanized sheet metal, from South Korea. These previously were supplied almost exclusively through long-term buyer-supplier relationships. Japan now imports more television sets than it exports each year.

This transformation in the economy is one of the main reasons that growth in Japan is forecast to be slower for the next decade. When Japan was in the process of playing industrial catch up, almost all major industries could grow at high rates. Now, however, many are at the technological frontier. They do not have that gap to exploit. Not only is growth in the industries of the future slowing, but growth in some traditional industries has turned from positive to negative.

BUSINESS PRACTICES

Within sectors, businesses are having to adjust to the new climate of low growth and high yen. Japanese businesses are facing problems with excess labor and the need for restructuring. In the 1980s, Japanese companies confronted a tight labor market with insufficient numbers of new college recruits. Now they tend to have surplus employees, particularly in middle management.

Japanese companies are having to become lean and mean. That might seem strange to say, since many Americans think of Japanese companies as already being lean and mean—if not lean at least mean? (tenacious) in their pursuit of market share. Actually, in their production processes, Japanese companies already tend to be lean and mean. Systems of just-in-time inventory, zero defects, and cost reductions have long been a part of their manufacturing processes. These apply only to production, however. Relative to production workers, middle management and white collar workers are considerably less efficient. Desktop computers, for example, are less widespread than in the United States, and women tend to be underutilized. Combined with a general aging of Japan's population and an aging of the work force within companies, Japan's businesses now face a difficult situation.

Japanese businesses also are discovering that business philosophies and management practices that they considered to be based on their culture are highly dependent on rapid economic growth. As long as domestic and foreign markets were growing rapidly, Japanese companies could pursue traditional Japanese-style business methods. Once the economy slowed, however, compa-

[8] Data for 1973 for some high-technology sectors, such as semiconductors, computer displays, and integrated circuits are not reported separately. These sectors experienced high growth. Passenger car production is also included in the transportation equipment sector.

nies have been compelled to shift more toward market-based practices common in other industrialized nations.

Japan's businesses found that as long as production was growing at high rates, they could promise permanent employment, promote by seniority, have automatic annual wage increases, focus on market share rather than profitability, train workers, and aim for the long-term. Companies also could hardly make mistakes in an economy doubling in size every seven to fifteen years. In fact, during the heyday of Japanese growth, the gravest errors a business could commit would be to underinvest in productive capacity, not hire a sufficient number of young workers, or allow its market share to erode even though its profits were high.

When growth slows and profits are squeezed, however, the relative cost of these practices becomes more apparent. What good is a long-term strategy for tomorrow if the company is faced with bankruptcy today? Under recessionary conditions each of these practices has been called into question. Companies now are confronted with excess capacity, surplus employees,[9] and insufficient resources to wage battles for market share that may debilitate profits.

Over the next decade, Japanese managers likely will continue to act as though they still hire employees permanently and follow other typical Japanese practices. They will have to temper those practices, however, with more flexibility. The net result will likely be a work force less loyal to a company and less willing to provide uncompensated overtime work. This could be offset, however, by more freedom by companies to discharge excess employees and raise the productivity of those left. This restructuring may raise company profits and worker productivity, but it also may raise the rate of unemployment unless those being discharged find other jobs. In the short-term, restructuring does not necessarily lead to higher growth for the total economy. It does imply, however, that U.S. companies seeking skilled and experienced employees in Japan now have greater prospects of finding them.

ASIAN TRADING BLOC

Since the end of World War II, Japan has depended heavily on the American market for its exports and imports. For the past two decades, the United States has accounted for about a quarter of all Japan's trade (26.7 percent in 1993).

A recent trend in Japan's pattern of imports and exports, however, has been its increasing reliance on imports from and exports to its neighbors in Asia. In 1992, the six Association of South East Asian Nations (Indonesia, Brunei, the Philippines, Singapore, Malaysia, and Thailand) accounted for 28.5 percent of Japan's total trade. China, Hong Kong, Taiwan, and South Korea together accounted for another 19.5 percent for a total for East and Southeast Asia of 48.0 percent—nearly half of Japan's trade.

Except for China, Indonesia, and Brunei, Japan runs a sizable surplus in its balance of trade with these nations. Its total merchandise trade surplus with these economies of $77 billion in 1992 nearly doubled the $44 billion it reported for its surplus with the United States.

Over the next decade, Japan's trade with its Asian neighbors is likely to continue to rise faster than its trade with the United States or other major trading partners. Its trade surpluses with these nations also is expected to remain

[9] In terms of the official unemployment rate, it is likely remain in the 2.5 to 3.0 percent range over the next decade. The number of surplus employees who remain on Japan's payrolls, however, is likely to remain high even after the economy recovers from the current recession.

high. These Asian nations, therefore, have a common interest with the United States in market opening in Japan. The United States, moreover, also has an interest in opening markets in many of these Asian economies but increasingly is being viewed in a negative light because of the pressures it places on these countries to liberalize their markets.

A question is how to pursue a trade policy over the next decade that will achieve greater access not only to the Japanese economy but to its neighbors in Asia. The United States likely will continue to rely on negotiations, external pressures, U.S. trade law, and international organizations such as the General Agreement on Tariffs and Trade (World Trade Organization). But one option remains open that seems not to have been fully explored.

Currently, the only trading bloc in Asia is AFTA, the ASEAN Free Trade Area, which encompasses the six countries of ASEAN. The goals of AFTA, however, are modest and progress slow. The Asia Pacific Economic Cooperation (APEC) council includes membership by the East and Southeast Asian nations as well as the United States, Canada, Mexico, Australia, and New Zealand. Discussions of trade liberalization under this organization have been initiated, but no concrete measures have been taken.[10]

Malaysia's Prime Minister has proposed the EAEC, the East Asia Economic Caucus, that would be restricted to Asian countries. The United States has opposed the EAEC primarily because of the threat that it would adopt policies adverse to U.S. interest or become a trading bloc. The prospect of a yen-dominated trading arrangement dominated by Japan also has not been welcomed.

In view of the increasing size of the Asian economies, their rising trade among themselves, and relatively less trade with the United States, however, an alternative long-term strategy might be for the United States to encourage free-trade areas (FTAs) in Asia. Such a strategy would bear certain risks, since such FTAs could raise trade barriers against the United States or form alliances in international organizations to oppose U.S. positions.

On the positive side, however, such Asian FTAs could work to reduce trade barriers in Asia without American pressures and negotiations. Under a Japan-South Korean or Japan-ASEAN FTA, for example, some of the burden of negotiating market opening could be shifted to the Asian nations, themselves. They would have to cut tariffs and eliminate nontariff barriers within their own economies. If Asian markets become more open, U.S. companies could then take advantage of opportunities, and particular barriers to U.S. exports could become easier to identify. Negotiations over those barriers could then be pursued.

[10] See: U.S. Library of Congress. Congressional Research Service. *Asia Pacific Economic Cooperation (APEC) and the Indonesia "Summits"* in 1994. CRS Report No. 94-242E, by Dick K. Nanto. Washington, 1994. 6p.

PREPARED STATEMENT OF MR. TEZUKA

Recent economic statistics show slight and slow recovery of Japanese economy. After long recession, finally Japanese economy seems to start moving upward. However, this does not necessarily mean that Japan has been cured from the crash of bubble economy.

The impact of the bubble crash is more than publicly understood. For example, the total value of stocks held by Japanese corporations devaluated by 194 trillion yen between 1989 and 1992. From 1990 to 1992, the total land asset value held by Japanese companies also devaluated by 143 trillion yen. As a sum, Japanese corporations lost 337 trillion yen from their asset base. This is almost 70% of the GNP of Japan.

Those assets have been built and kept held for many years, and they are recorded on balance sheets with its historical value, rather than current market value, creating huge credit line to Japanese companies. In other words, Japanese companies were raising capital, making investment, and expanding operations by using this huge "hidden value asset" so called "Fukumi-shisan". Japanese corporations' competitiveness during 1980s was depend upon this "hidden asset base". The bubble crash means the end of this "management with hidden assets".

Sudden disappearance of asset value by 70% of GNP caused serious credit problem for Japanese banks. Officially announced top commercial banks' and top credit banks' bad loan amounted to 13.7 trillion yen, and an other private calculation estimated it to be more than 60 trillion yen. This number is by far the larger than the bad loan once held by American banks in 1991 at its peak ($120 billion). Japanese banks are not as healthy as they looks like.

Japanese corporations are actually loosing profitability. Even during economic boom between 1985 and 1991, 8% of the total pre-tax profit of Japanese public corporations was from sales of holding stocks. 10.3% was from sales of land properties. Japanese companies' return of equity is constantly less than half of the ROE of American counterparts', and even such low profitability was supported by realization of "hidden asset value" by selling of stocks and land. In this sense, Japanese companies' economic prosperity was a kind of illusion.

As the result of bubble crash, most of the Japanese corporations are suffering from financial difficulties. Its seriousness is much worse than the surface phenomena. For example, Nissan reported only 15 billion yen loss in 1992, but her consolidated loss amounted to 55 billion yen. In the same year, NEC reported 16 billion yen profit, while her consolidated loss was 45 billion yen. Thus Japanese corporations are making-up their financial reports by carrying over losses to their subsidiary companies.

Facing such serious economic conditions, Japanese companies have finally started reducing the number of employees. From 1990 to 1993, NTT, Japans largest company, reduced employees by 25,429, which is 9.9% of the total employment. Nissan cut by 3800 and Nippon Steel cut by 2200.

Future plan is much more shocking. Nissan announced that they will further reduce employment by 5000 by 1995. NKK, which is my company, decided to eliminate 4500 employees. Among them, 1000 is white collar employees. Nippon Steel also announced to reduce 7000 employees with 3000 white collars. As a sum, one calculation estimates that around one million jobs will be disappear from Japanese top corporations within three years.

Japanese lay-off is done silently and secretly. Japanese corporations are dispatching out those excess employees to subsidiary companies, where they may not find responsible positions. Those subsidiary companies are laying off

their original employees to outside to keep spaces open for dispatchers from parent companies.

Japanese companies also stop recruiting new college graduates. In the past two years, and probably for a few more years, about 200,000 college graduates are not able to find jobs every year. Especially female students are facing miserable situation in job hunting. Sooner or later, this can be a cause of serious social problems.

Does this mean the end of lifetime employment? I think this is the beginning of the new era in Japanese work environment. Current official unemployment ratio in Japan is around 2.5 - 3.0%. But it is said that if you add potential unemployment, which is kept held by companies as in-company job-less employees, the figure will increase to 7%. Facing with rapid and constant appreciation of yen, Japanese corporations cannot continue holding such excess employment as a social welfare.

Especially baby boomers are facing difficulties. Japanese baby boomers are now between 38 and 43 years old. They joined big corporations as a mass during Japanese expansionary economy in 1970s. They have been working hard to make companies bigger and bigger, and climbing up the career ladders. But suddenly faced with deflationary economy, they finally realize that there are very few higher positions available for them.

Many Japanese big corporations start introducing new human resource management systems. For example, Matsushita Electric introduced contract base researcher positions, which offer higher annual wages with limited time employment guarantee. Nissan also reformed her wage system from seniority base to merit base system. Many companies introduced early retirement bonus system and other incentives to leave companies earlier than official retirement ages. In short, companies are not willing to pay wages for employees unless they contribute by their professional skills. This is the end of traditional lifetime employment.

In this trend, there are strong (potential) generational conflicts. During continuous growth period, Japanese corporate environment has been firmly structured. Promotion was based upon seniority under lifetime employment. Now average age of chairman of big corporations is 69.8 and presidents' is 61.7. Average age of corporate directors increased from 58.2 in 1990 to 58.5 in 1993. Those elder executives don't resign and stick to their positions longer and longer.

As I mentioned earlier, those executives are making-up financial performances of the companies by selling off the hidden assets, which are the savings from the past prosperity, to avoid being criticized for their mis-management. General managers, who are usually 50 to 55 years old believe that traditional Japanese corporate system may not change for the next five years or so, and that hidden assets may not be consumed up in the same period. Therefor, they think it is better for them to stick to traditional management system, which is based upon "hidden asset" value, rather than giving up and restructure it. They prefer such low-risk environment.

Knowing this, current middle managers are accusing higher executives of their irresponsibilities during bubble economy and current economic difficulties. They start understanding that there may be no past savings available for them in a few years, and even they may not be able to receive enough pension and retirement bonus. Much younger generations are, as I mentioned, not able to join those established corporations.

This is the description of current Japanese corporate environment. In a nut shell, Japanese companies are facing a fundamental question: that is whether

they can keep traditional management system or not. My conclusion is that this is the end of traditional Japanese management. To keep hidden asset base management, together with lifetime employment, there must be continuous inflation of asset value, supported by rapid real economic growth. Traditional management system is the system which allow "Low-risk High-return" situation with steady rapid growth. However, Japanese economy has already been slowing down after 1980s. Bubble crash evidenced that Japan cannot keep 5-7% growth for long time.

Under expansionary economy, Japanese management system generated enough cheap capital available for companies to invest, and expanding positions for employees. But under slower economic growth, the same system functions to accelerate economic problems. Japanese corporations must change their management system. Otherwise, they are forced to go back to "Low-risk Low-return" or even "Low-risk No-return" situation, and consuming up all the past national wealth.

The biggest question is whether Japanese managers are ready to take high risk to pursue higher returns. They have been, in the past decades, accustomed to low-risk environment. There is no "capitalist mind" among Japanese managers.

Japanese banks have become extremely conservative in landing loans. Banks are charging interest margin between savings and loans by 4 to 5% to keep their profit enough to sustain huge bad loans. This higher loan interest together with asset base crash prohibit industries to invest on new business opportunities.

Japan as the world second largest economy does have enough resources to sustain sound economic growth such as high-technologies, efficient production systems, and skilled labors. But if she lacks in "capitalist mind" which utilize the resources to generate new industries and further wealth, she will be getting into declining economic cycle.

There seems to be two scenarios for the future of Japan. The first scenario is that, as the virtue of traditional Japanese management, she tries to recover from recession by sharing pain by everyone, and by consuming up past savings under government's generous supports. Companies can wait for government's economic stimulus, and incrementally reduce cost to keep competitiveness under strong yen era. This scenario may be easy to follow, but may not solve the fundamental problems of Japanese economy which I described. People may stick to traditional employment system, and may not want to take risks to change it. Everyone follows others and relies upon government support, then gradually lose economic dynamism. Once they succeed in reducing cost by incremental measures, further appreciation of yen may put another burden on them. The first scenario is merely a temporally cure, and may bring larger problems.

The second scenario is pursuing fundamental restructuring of the management system. Giving up helping relatively weaker players like less competitive companies and in-company unemployment, Japan can make stronger players more competitive. At the same time, dropping out of less efficient players may reduce excess capacities in industries, loosen export pressures, then finally depreciate yen against other currencies.

Companies are to be evaluated not by their holding assets, but by their ability to create values from operations. More prosperous companies can raise low cost capital, and less productive companies may force to pay expensive cost unless they commit to restructure their businesses.

Releasing trapped resources, financial and human, from such weaker side of the economy to other business opportunities may generate much more wealth. Removing government regulations, which are estimated to control more than half of the economy, may create new business opportunities. Giving up government help is painful, but may brings "capitalist mind" among corporate managers. This scenario is painful, because there must be clear distinction between winners and losers. But again, as I mentioned, Japan cannot keep inflationary economic growth by sharing risks and pains by everyone.

In conclusion, Japanese corporation's resurgence and its economic growth is depend upon whether Japan can successfully follow the second scenario by stimulating "capitalist mind" among corporate managers who is willing to take business risks. Regulations and bureaucratic controls over economy will be the biggest obstacle for this to happen. Younger managers, who may suffer more from keeping current system may take the key role for this movement. Ironically, the impact of the crash of bubble economy may be strong enough to force Japan to take the second scenario, though many people still believe in the first scenario.

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